STRENGTHENING YOUR CD PENALTIES

by Steve Brown

If you have not restructured your CD offerings, consider this another reminder. Several months ago we presented our analysis of the percentage of customers that will break their CDs when rates start to rise and pay the penalty. As detailed then, the current need for income, the media's focus on banking and the extended period of low rates have made depositors more interest rate sensitive and less penalty sensitive. Our estimates ranged from a high of 40% could approach you to cash-out, with a mean of around 15%.

Hopefully, you are already using our BLP Product to hedge your interest rate risk when it comes to loans and attending our upcoming EMC Conference to gain further insight how to build out your cash management platform to better capture non-maturity deposits, extend duration and increase positive convexity. If you are one of the approximately 4,600 banks that hedge their fixed rate securities and loans by way of funding them with longer term CDs, then take note because things could become quite costly once the Fed begins to raise rates.

Assume for the moment that you have issued 3Y CDs at a 1.20% rate that carry a 3 month prepayment penalty. That is only $30 per $10,000 of deposits in cost for a customer to cash in and reinvest into a new CD at a higher rate. If rates were to move sharply up within 6 months of issuance by 100bp, depositors might have a $220 net incentive to do just that. Conversely, your bank would be out that amount. Multiplied over a $100mm liability portfolio of CDs, this risk could be an additional cost to your bank of approximately $440k (assuming a 20% redemption rate).

In addition to our past suggestion of attempting to move accounts into longer duration products, such as goal-oriented accounts, automated saving plans, HSAs/IRAs etc.; we also suggest banks increase their penalties (to include either a longer maturity of penalty interest, a flat fee or both). Because of the current market volatility of interest rates, this option is valuable to the customer in this rate environment. Put another way, a CD is really just a contract where banks pay a higher rate to lock the funding in for a longer maturity. As such, a higher penalty is warranted to protect the bank's investment in duration. Comparatively, if a customer purchased a CD from their investment broker and needed to redeem early, they would be subject to market conditions and run the risk of being hit with 100% of the difference in interest, plus transaction costs.

We point out that at the end of last year; JP Morgan increased its penalty rate to $25 per CD, plus 3% of the notional amount to protect against this issue. In addition, just a couple of months ago, Bank of America matched by quietly raising their penalties to an almost identical level (by tiering their fee at 1% for CDs less than 1Y and 3% for CDs longer than a year). Many community banks have also increased penalties to a year's worth of interest.

Taking another look at your early redemption penalty structure now, may save your bank thousands of dollars down the road. Running scenarios to see what impact a 20% early redemption run could have on your bank is also suggested. Finally, training your account staff to handle questions on early redemption and providing another product such as a "Flex-CD" (that might pay a higher rate, but give both your bank and your customer the right to redeem at set call rates) may help thwart problems with customer satisfaction. Whatever path you choose, given the rate environment, it pays to work now to prevent problems later.

BANK NEWS

Slower Foreclosure

Driven by a backlog and a slowdown in processing to ensure paperwork is correct, foreclosures nationwide in the 1Q increased to an average 400 days (to go from default notice to the day the bank reclaimed the property) according to RealtyTrac. That is up from 340 days 1Y ago.

Branches

BancorpSouth ($13.5B, MS) will shut 23 branches this year (about 8% of its total), in an effort to save an estimated $4.4mm per year.

Borrowing Steady

A study by Fidelity finds 22.1% of people tapped their retirement savings and had a loan outstanding as of the 1Q, down slightly from 22.5% in 2010.

Seller Financing

Research by the NAR finds the number of homes purchased with owner financing has jumped 56% from 2008. On a relative scale, however, these transactions still only account for 1.5% of all transactions.

ATM Fee Test

JP Morgan Chase, after testing a $4 foreign ATM fee in TX and a $5 ATM fee in IL, has decided to go back to its standard $3 charge due to price sensitivities of demand.

Twittering

Research from Cornell University and Yahoo finds 50% of all tweets on Twitter are generated by only 20,000 users. That means less than 0.05% of Twitter users drive commentary on the service.